

**California Actuarial Advisory Panel  
First Page Letterhead**

September xx, 2010

Director of Research and Technical Activities  
Project 34  
**Governmental Accounting Standards Board**  
401 Merritt 7, PO Box 5116  
Norwalk CT 06856-5116

**Re: Preliminary Views of the Governmental Accounting Standards Board:  
Pension Accounting and Financial Reporting by Employers**

The California Actuarial Advisory Panel (the Panel) appreciates the opportunity to provide the Governmental Accounting Standards Board (GASB) comments on the Preliminary Views for Pension Accounting and Financial Reporting by Employers (Preliminary Pension Views). The Panel was established with the enactment of California Senate Bill 1123 (Chapter 371 of the Statutes of 2008). Pursuant to Government Code Section 7507.2(a):

*“...the panel shall provide impartial and independent information on pensions, other postemployment benefits, and best practices to public agencies...”*

Legislation to create the Panel was recommended by the Public Employee Post-Employment Benefits Commission in a January 2008 report to Governor Schwarzenegger.

The Preliminary Pension Views asked for comments related to six issues:

- Issue 1—An Employer’s Obligation to Its Employees for Defined Pension Benefits**
- Issue 2—Liability Recognition by a Sole or Agent Employer**
- Issue 3—Measurement of the Total Pension Liability Component of the Net Pension Liability by a Sole or Agent Employer**
- Issue 4—Attribution of Changes in the Net Pension Liability to Financial Reporting Periods by a Sole or Agent Employer**
- Issue 5—Recognition by a Cost-Sharing Employer**
- Issue 6—Frequency and Timing of Measurements**

The Preliminary Pension Views are a significant departure from GASB Statement Nos. 27 and 45, in that both these statements link accounting and funding, requiring a plan sponsor to recognize an obligation if they do not pay the actuarially determined contribution. The preliminary views do not say why GASB is considering moving away from accounting cost measures that are closely related to and consistent with funding cost measures. We strongly believe the linkage between accounting and funding costs should not be broken and that even if there are differences that (1) both accounting and funding measures of cost should be incorporated in the financial statements and (2) any differences should be identified, and well understood [justified?].

Ultimately, accountability and interperiod equity can only adequately be measured based on whether a plan sponsor has or has not made actuarially determined contributions to fund their plan. We are very concerned that recognition of the Net Pension Liability and proposed attribution of changes in Net Pension Liability, if not determined on a basis consistent with plan funding, will make it more difficult to measure plan sponsor accountability and assess interperiod equity. As an example, those of us that work in the OPEB area are now seeing plan sponsors recognize the importance of pre-funding those obligations. That recognition did not happen before GASB Statement No. 45 and will likely not continue if the preliminary views are applied to OPEB. Similarly, if there are few or no reporting implications to an employer not making pension contributions, in today's economic environment, more pension plan sponsors will consider not making the actuarially determined contribution.

Furthermore, the Panel believes that the concepts of interperiod equity and the employment exchange apply to both accounting and funding. This means that these two measures of pension cost are essentially similar and should be based on the same actuarial methods. Note that the preliminary views come to this same conclusion in selecting a level cost attribution method (Entry Age) and discount rate (long term expected earnings) for plans that are funded on an actuarially determined basis.

The Panel acknowledges that continuing the linkage between accounting and funding will require more rigorous standards for actuarially determined contributions. This will most likely require the actuarial profession to establish standards of practice for public plan funding, as well as qualification standards for public sector (pension and OPEB) actuaries. We have a project on our 2011 work plan that will provide recommendations along those lines to the American Academy of Actuaries, and we are aware of similar work by other organizations of public sector actuaries. We recognize that it is up to the public sector actuaries to establish appropriate public sector funding standards that the accounting profession can rely on.

We appreciate the opportunity to respond to the issues raised in the Preliminary Views. Following are our comments related to the issues. For some of the issues raised, we have responded that we agree with the position expressed by GASB; however we note that there may be worthy special exceptions and that these exceptions should be carefully considered in the implementation guidelines.

1. *For accounting and financial reporting purposes, an employer is primarily responsible for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits.*  
**We agree with this view.**
- 2a. *The unfunded portion of a sole or agent employer's pension obligation to its employees meets the definition of a liability (referred to as an employer's net pension liability).*

**We agree with this view.**

- 2b. The net pension liability is measurable with sufficient reliability to be recognized in the employer's basic financial statements.

**Generally we agree with this view but with some important qualifications. Just because a liability can be measured reliably at a point in time does not mean it is necessarily useful to the reader of the financial statements, or that it can be measured in a reliably useful way over different accounting periods.**

**We are concerned that the methods proposed in issues 2 & 4 (a Net pension Liability based on market value of assets and rapid recognition of changes in that Net Pension Liability), will lead to significant volatility in both the Net Pension Liability and annual pension expense, resulting in the information not being useful. If, as will happen from time to time, significant volatility occurs, this will reduce the financial statement user's ability to determine a government's accountability for benefits and to reasonably assess interperiod equity from one year to the next.**

**We believe that consideration should be given to the relative quality of the accounting measurement of net pension liability in comparison to other accounting liability measurements on the balance sheet, such as the value of buildings, equipment and cash payables. Since the balance sheet does not display or measure the quality of the measurement shown, having the net pension liability on the balance sheet with other liabilities would mislead users into believing that the accounting measure of the net pension liability is of the same quality as the other measurements. Because the net pension liability is based on future predictions and its time horizon is several generations', the quality of the measurement of net pension liability is well below that of other balance sheet assets. We believe that, based on accounting principles, the net pension liability as proposed bests fits the definition of a contingent liability and should be disclosed in the footnotes of the financial statements.**

**The size of the proposed net pension liability will likely dwarf other values on the balance sheet and give users a misleading and distorted view of the financial position of an employer. If the net pension liability is viewed as an equivalent liability to other entries on the balance and taken to its logical conclusion, the huge size difference between the proposed net pension liability and other balance sheet assets would lead users to pay little attention to the other assets, thus reducing accountability of the employer for other activities.**

**We believe (as required under GASB Statement No. 27) the current recognition of a Net Pension Obligation provides a better indication of accountability and the contribution-based Annual Pension Cost a better measurement of interperiod equity. However, if the Board believes the Net Pension Liability should be recognized in the employer's financial statements,**

**we suggest the Board consider the following additions to the recognition requirement:**

- i. The Net Pension Liability should be determined using a smoothed(or “actuarial”) value of assets rather than a market value of assets.**
- ii. The initial Net Pension Liability, through an offsetting transition asset, be recognized over a reasonable (e.g. 10 or 15 year) period and**
- iii. The Net Pension Liability be separated into two components:**
  - (a) the portion similar to the current NPO calculation, based on an actuarially determined contribution and**
  - (b) the remainder of the Net Pension Liability.**

3a. *The projection of pension benefit payments for purposes of calculating the total pension liability and the service-cost component of pension expense should include the projected effects of the following when relevant to the amounts of benefit payments:*

- (1) automatic cost-of-living adjustments (COLAs),*
- (2) future ad hoc COLAs in circumstances in which such COLAs are not substantively different from automatic COLAs (see also question 3b),*
- (3) future salary increases, and*
- (4) future service credits.*

**We agree with this view.**

3b. *What criteria, if any, do you suggest as a potential basis for determining whether ad hoc COLAs are not substantively different from an automatic COLA and, accordingly, should be included in the projection of pension benefit payments for accounting purposes?*

**Absent action by the governing board to the contrary, we believe past action to grant ad hoc COLAs should be an indication of future actions. This approach follows the substantive plan approach of GASB Statement No. 45.**

3c. *The discount rate for accounting and financial reporting purposes should be a single rate that produces a present value of total projected benefit payments equivalent to that obtained by discounting projected benefit payments using:*

- (1) the long-term expected rate of return on plan investments to the extent that current and expected future plan net assets available for pension benefits are projected to be sufficient to make benefit payments and*
- (2) a high-quality municipal bond index rate for those payments that are projected to be made beyond the point at which plan net assets available for pension benefits are projected to be fully depleted.*

**We agree with the 3c(1) view and commend the GASB for the use of the long-term expected return on assets as the basic discount rate. However when projecting assets for this calculation we believe GASB should clarify that the assets do indeed include “contributions from all sources related to funding the**

**benefits of employees currently in the plan”, regardless of how those contributions are expressed.**

**We disagree with the 3c(2) view. We are concerned that, while this view might have some attraction because it is consistent from one employer to the next, it might lead to unreasonable results based on then current, bond rates. We suggest use of the concept, as stated in GASB Statement No. 45, that the discount rate should be based on the estimated long-term investment yield for the source of funds expected to be used to finance benefit payments. This view results in our suggestion that 3c(2) above be changed to “the expected return on employer assets for those payments that are projected to be made beyond the point at which plan net assets available for pension benefits are projected to be fully depleted.” Because this rate might vary from one plan sponsor to the next, some might argue that it will make it harder to compare results between plan sponsors. However, we believe this suggested alternative better represents the value of the obligation.**

- 3d. For purposes of determining the total pension liability of a sole or agent employer, as well as the service-cost component of pension expense, the present value of projected benefit payments should be attributed to financial reporting periods over each employee’s projected service life using a single method—the entry age actuarial cost method applied on a level-percentage-of-payroll basis.  
**We agree with this view, and commend the GASB for the use of a level cost of service attribution method, consistent with the pay related nature of the career-long employment exchange.**

- 4a. The effects on the net pension liability of changes in the total pension liability resulting from (1) differences between expected and actual experience with regard to economic and demographic factors affecting measurement, (2) changes of assumptions regarding the future behavior of those factors, and (3) changes of plan terms affecting measurement should be recognized as components of pension expense over weighted-average periods representative of the expected remaining service lives of individual employees, considering separately (a) the aggregate effect on the liabilities of active employees to which the change applies and (b) the aggregate effect on the liabilities of inactive employees.  
**We disagree with this view, especially as it applies to gains and losses (i.e., differences between expected and actual experience) and to assumption changes. Implementing this view will create significant expense volatility from one period to the next, inconsistent with the long-term nature of the employment exchange.**

**The nature of gains and losses is than even the most accurate actuarial assumptions are not meant to predict what will happen from one particular year to the next. Requiring gains and losses to be recognized immediately for inactives will punish or reward current year tax (or rate) payers only to**

reverse results the next year or years. This produces an inequitable allocation of the ultimate cost across reporting periods and so is not consistent with the principle of interperiod equity.

The proposed treatment of assumption changes have a similar but perhaps even worse effect. A change in assumptions for inactive liabilities (e.g., earnings assumption or mortality) would cause the entire remeasurement of liability to be expensed in a single reporting period. Again this is inconsistent with the long-term employment exchange as well as violating a reasonable understanding of interperiod equity.

While we appreciate the desire to expense each member's entire liability over that member's service period, we submit that this is not an attainable goal in light of the uncertainty inherent in pension cost measurements. This requires attribution periods that are not strictly limited to the expected remaining service lives of individual employees.

We strongly suggest the Board consider amortizing (recognizing) changes over reasonable periods and further, using different amortization periods for gains & losses, method & assumption changes and benefit changes. A reasonable approach might be:

- i. Gains & losses amortized (recognized) over 10-15 years. It might be reasonable to amortize inactive related gains & losses over a shorter period than active related gains & losses.
- ii. Method & assumption changes amortized over 15-20 years. Assumption changes are a recognition that current assumptions, if left unchanged, will result in future gains or losses. This justifies a somewhat longer amortization period than used for gains & losses.
- iii. Benefit changes amortized over 1-10 years, depending on the nature of the change. For example it might make sense to amortize early retirement window changes over very short periods (1-3 years) while amortizing formula changes over a longer period, such as liability weighted average future working lifetime.

Ultimately the recognized expense should be a balance between immediate recognition of changes (which may achieve *intergenerational* equity but at the sacrifice of interperiod equity) and volatility mitigation. The goal should be to strike a balance between these two over some reasonable duration so that readers of the financial statement can determine if the current path is fiscally sustainable based on a consistently reported level of expense over time. We believe the above approach strikes a much better balance over the life of a tax payer.

- 4b. The effects on the net pension liability of projected earnings on plan investments, calculated using the long-term expected rate of return, should be included in the



determination of pension expense in the period in which the earnings are projected to occur. Earnings on plan investments below or above the projected earnings should be reported as deferred outflows (inflows) unless cumulative net deferred outflows (inflows) resulting from such differences are more than 15 percent of the fair value of plan investments, in which case the amount of cumulative deferred outflows (inflows) that is greater than 15 percent of plan investments should be recognized as an increase or decrease in expense immediately.

**We disagree with this view for a few reasons:**

- i. **While not described as an asset smoothing method, the suggested method in fact provides “infinite” smoothing within a relatively narrow “corridor” and no smoothing outside the corridor. For example, If assets increase by 5 percentage points over the assumed return four years in a row, there would be no recognition of the first 3 years of gains and then full recognition of the gain in the fourth year.**
- ii. **Economic and investment swings don’t happen in one year increments. Instead we are more likely to have 2-5 years of good returns followed by 2-5 years of bad returns.**
- iii. **While future returns are expected to average out to the long-term assumed return, that does not mean we can count on future returns to mirror and so offset past experience in the short term.**

**We suggest that the using a smoothed asset value based on established actuarial methods and standards, rather than relying solely on the corridor approach as proposed. As noted under Issue 2b and discussed further below, this smoothed asset value would be used to determine the NPL, and so would also determine the changes in NPL that are addressed here under Issue 4b.**

**Such a smoothed asset value would have the following attributes:**

- i. **Must be market related.**
- ii. **Recognition period: Period over which annual variations of market returns from assumed returns are recognized.**
- iii. **Corridor: Range around the market asset value that the smoothed asset value must remain within.**
- iv. **Generally the shorter the recognition period the wider the corridor can be and the longer the recognition period the narrower the corridor should be. In particular, if the recognition period is sufficiently short, then a corridor may not be necessary or desirable. For example a 10 year recognition period might have a 20% corridor while a 5 year recognition period might have no corridor or a very wide corridor.**

**As for a specific recommendation, we would recommend a five year recognition period with either no corridor or a corridor as wide as 135% to 140%. While we are aware that this seems extreme we would be happy to provide the recent experience and analysis that supports this recommendation.**

**Finally there is an important relationship among Issues 2a (balance sheet reporting), 4a (amortization) and 4b (investment volatility).**

- i. As discussed under Issue 2a, in order to be measurable with sufficient reliability, the NPL should be based not on market value assets but on a smoothed value. That smoothed value is described in this section, just above.
- ii. Changes in that smoothed asset value greater or less than assumed will result in changes in the NPL “resulting from differences between expected and actual experience with regard to economic ...factors affecting measurement”, i.e., gains and losses in the NPL.
- iii. Those smoothed asset value gains and losses should be amortized similar to the liability related gains and losses discussed under 4b.

We wish to be clear that this has the effect of managing investment volatility in two ways; first by asset smoothing (as part of determining the NPL) and second by amortizing unexpected changes in the NPL that are due to changes in the smoothed asset value. This is consistent with the fact that investment return experience has far more short term volatility than any of the demographic experience affecting plan liabilities, and so requires a separate smoothing mechanism before being amortized along with other elements of plan experience.

- 5a. Each employer in a cost-sharing plan is implicitly primarily responsible for (and should recognize as its net pension liability) its proportionate share of the collective unfunded pension obligation, as well as its proportionate share of the effects of changes in the collective unfunded pension obligation.

**We agree. (See above questions on our view on how the net pension liability should be calculated.**

- 5b. Basing the determination of proportionate shares of the collective net pension obligation on employers' respective shares of the total annual contractually required contributions to the plan and believes that would provide a reliable basis for measurement. However, the Board is seeking constituent input regarding other basis, if any, do you suggest for determining a cost-sharing employer's proportionate share of the collective net pension obligation?

**We agree that basing the employers' net pension obligation on the respective share of the total annual contractually required contributions is a practical method of allocating the net pension obligation. However, we do not believe that it is a consistently accurate method of determining the employers' share of the net pension obligation.**

6. A comprehensive measurement (an actuarial valuation for accounting and financial reporting purposes) should be made at least biennially, as of a date not more than 24 months prior to an employer's fiscal year-end. If the comprehensive measurement is not made as of the employer's fiscal year-end, the most recent comprehensive measurement should be updated to that date. Professional judgment should be applied to determine the procedures necessary to reflect the effects of significant changes from the most recent comprehensive measurement date to the employer's fiscal year-end. Determination of the procedures needed in the particular facts and



circumstances should include consideration of whether a new comprehensive measurement should be made.

**We agree with the biennial valuation requirement. However, we are very concerned with the requirement that results be updated to the employer's (current) fiscal year-end will result in logistical challenges and unnecessary consulting fees. A better approach would be to require the valuation be updated, if necessary, to the employer's previous fiscal year-end. For example results for June 30, 2010 must be used in the plan sponsor's June 30, 2011 financial statement. The footnote could mention (without quantification) any subsequent events that occurred between the prior and current fiscal year ends.**

We would like to testify in person at the GASB's October 14, 2010 (San Francisco) public hearing. Again, thank you for the opportunity to comment on the Preliminary Pension Views and any consideration you provide to our comments.

Sincerely,

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Chair, California Actuarial Advisory Panel

c Panel members:

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